INTERPROVINCIAL HARMONIZATION OF TRUST AND LOAN COMPANY LEGISLATION

Ministers Responsible for Financial Institutions

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INTERPROVINCIAL HARMONIZATION OF TRUST AND LOAN COMPANY LEGISLATION

1. Background

Provincial ministers responsible for regulation of financial institutions first met in December, 1988, in Quebec City to identify and initiate a process for making regulatory practices and legislation across provincial jurisdictions compatible. The ministers approved three resolutions:

1. to establish an Interprovincial Conference of Ministers on regulatory reform in the financial sector;

2. to adopt an interprovincial information-sharing agreement; and

3. to harmonize provincial legislation regulating financial institutions.

The primary objective in the "harmonization" process is to create a national regulatory environment for provincial institutions. In so doing, the provinces' intention is to remove unnecessary interprovincial barriers in the interests of fostering efficient financial markets and to ensure congruent regulatory standards. More particularly, the purpose of creating a national regulatory environment is to protect depositors and other financial consumers effectively while reducing the cost of the regulatory system to governments and financial intermediaries alike.

The provincial ministers explicitly recognized in Quebec City that harmonization does not necessarily require uniform legislation. Rather, the pursuit of a consensus on common standards and principles in key areas of regulation and, as a priority, the development of a consistent approach to provinces' treatment of extraprovincial companies, would produce significant progress toward the objective. The attached appendices set out the significant results achieved so far.

The key areas which have been identified so far for harmonization are minimum capital requirements, capital adequacy, corporate powers, investment rules, non-arm's length transactions, financial reporting and

auditing. With the establishment of the Interprovincial Conference of Ministers harmonization in other areas of regulation could be pursued as circumstances require.

The purpose of this document is to summarize the agreements made to date between provincial ministers responsible for financial institutions with respect to information sharing on, and harmonization of, financial institution legislation and regulation.

2. Information-Sharing Agreement

In October, 1988, western ministers responsible for regulation of financial institutions signed an intergovernmental agreement on information-sharing on financial institutions operating extraprovincially. That agreement served as a model for a subsequent information-sharing agreement signed by nine provincial ministers in April, 1989, in Vancouver. Newfoundland signed the agreement in October, 1989. The principles of the agreement include a mechanism to share information related to enforcement and administration as well as draft legislation and policies, a requirement to notify other regulators of substantive regulatory actions, and a provision enabling regulators to consult and undertake joint inspections.

3. Interprovincial Harmonization

Moncton Meeting

At the third meeting of provincial ministers responsible for financial institutions in Moncton in August, 1989, ministers reached agreement on a number of principles for legislation regulating loan and trust companies and directed officials to work toward consensus on others.

A. Minimum Capital Requirements

Ministers agreed that provinces should have the flexibility to establish different minimum capital requirements, although institutions must meet the requirements of each province in which they operate.

B. Capital Base

Ministers directed officials to prepare a common definition of capital base.

C. Risk Weighting of Assets

Ministers directed officials to develop a model framework for assessing capital adequacy based on a risk-weighting of assets. As well, ministers directed that a set of investment rules be developed for their consideration, consistent with the model framework for the risk-weighted capital adequacy test.

D. Ownership

Ministers affirmed their position that commercial ownership of financial institutions not be prohibited. As well, ministers agreed that provincial rules on foreign ownership need not be uniform.

E. Core Trust Powers

Ministers agreed that financial institutions other than trust companies be prohibited from engaging in the trust business, although other financial institutions would be permitted to set up separately registered and regulated trust company affiliates.

F. Investment Rules

Ministers directed officials to develop a common set of quantitative investment rules, a common list of permissible subsidiaries, and a uniform definition of commercial loan.

G. Financial Reporting and Auditing

Ministers agreed that uniform regulatory reporting and regulatory auditing and accounting principles should be sought, directing officials to work with the Canadian Institute of Chartered Accountants.

Summary of Results from Harmonization Process

Since the August 1989 meeting of ministers, deputy ministers and officials have met with a view to developing harmonized legislative standards in the key areas identified by the ministers in Moncton. To date, the harmonization process has focused on loan and trust legislation only. Consultation with industry groups on

draft common reporting forms has been completed. To effect agreement in the key areas of harmonization ministers will recommend to their respective governments amendments to legislation or regulations.

A. Financial Reporting, Auditing and Accounting

One of the first directions agreed to by ministers at the Moncton meeting was to develop uniform regulatory reporting forms. The forms have been completed and will be implemented for the quarter ending March 31, 1991. Considerable input was provided to officials by the Trust Companies Association and accounting organizations in developing the forms.

Implementation of uniform reporting forms is a significant step toward harmonization and ministers expect that implementation of the forms will reduce unnecessary burdens placed on the industry by previously inconsistent reporting requirements. Transitional provision may be necessary to accommodate adjustments to the new forms by trust and loan companies.

Another topic identified by ministers in their Quebec City meeting was the possibility of developing common regulatory accounting and auditing principles. Officials are currently identifying issues to be examined in this area.

B. Liquidity

In developing the provincial forms, the subcommittee on reporting forms addressed differences among the various provinces' liquidity requirements and in conjunction with officials working on capital and investment rules, developed a standard liquidity requirement. The proposed liquidity requirement is similar to that contained in existing regulations, and is set out in Appendix 1.

C. Capital Base

The common definition of capital base is set out in Appendix 2, and is applicable to the traditional borrowing multiple approach. British Columbia will also be using the definition in applying the risk weighting approach to capital adequacy.

D. Risk Weighting of Assets

Discussions on the risk-weighted model are ongoing. Specific adjustments to the model are under consideration to require capital be set aside against concentration of risks geographically and in portfolio categories. Industry input will be invited as the model is further developed.

E. Minimum Quality Asset Rule

Ministers recognized the importance of ensuring prudent lending and investment standards consistent with the borrowing multiple approach to capital adequacy. One of the key standards agreed to by officials is the minimum quality asset rule, which would require companies to maintain a minimum of 45% of total assets in specified categories of investments such as first mortgages and Treasury Bills. The rule is set out in more detail in Appendix 3. Other quantitative investment rules are set out in Appendix 6 and discussed below under "Quantitative Investment Rules".

F. Commercial Loan Definition

To fulfil the direction given by ministers in Moncton to design a common definition of commercial loans, officials examined various models, including the definitions in Quebec, New Brunswick and Ontario legislation and in proposed federal and Alberta legislation. Recognizing that commercial financing is a rapidly changing area of intermediation, ministers directed that a standard definition and treatment of commercial financing be implemented by all the provinces either by statute and in the case of the capital threshold and upper 20% of assets limit, by regulatory policy. A standard treatment is particularly important given that increased commercial lending powers for trust and loan companies will allow companies to compete in commercial markets. The definition is attached in Appendix 4. Companies with less than $15 million in capital will be permitted to engage in commercial lending up to 5% of assets, but will require capitalization greater than or equal to $15 million and regulatory authorization to exceed the threshold.

G. Permissible Downstream Companies

Two categories of subsidiaries and associates were examined by officials in attempting to reach a

common list as directed by ministers: financial and ancillary. The types of downstream companies agreed upon reflect both the flexibility necessary for companies to diversify into new sectors and the appropriate degree to which depositors' funds may be invested prudently in separately incorporated and empowered subsidiaries. A common list is attached in Appendix 5. The provinces have also agreed to permit loan and trust companies to invest in 10 to 50% of the voting rights attaching to shares of the types of corporations eligible as subsidiaries (i.e.,"associates") subject to some controls. For example, provinces have agreed that there will be a maximum of 5% of assets which may be committed to investments in subsidiaries or associates. As well, some provinces will require prior regulatory approval for investments in some of the specified list of eligible subsidiaries or associates.

H. Quantitative Investment Rules

A number of other investment rules on which the provinces agreed are set out in Appendix 6. These include: a maximum on investments in "related" or "associated" persons to control exposure to common risks; a maximum on investments in equity other than in permissible subsidiaries or associates; aggregate limits on investments in subsidiaries or associates: and rules on the treatment of real estate acquired in foreclosure.

Agreement was also reached on an asset-based limit on investments in subsidiaries and associates of 5% of assets; excluding loan and trust subsidiaries or associates. As well, there will be standardized limits on portfolio investments in common shares (i.e., 10% of assets); investments in real estate, foreclosed property, and third and subsequent mortgages.

British Columbia, with a view to achieving a similar result in the context of the risk-weighted capital adequacy model, will place thresholds on certain types of investments in risk-weighting and requiring greater capital for these types above the thresholds.

4. Prospective Harmonization

With agreement on investment rules and the principles of capital adequacy including a definition of capital base, ministers are confident that the

standard of regulation across the various provincial jurisdictions will be consistent in these areas. Implementation of the common reporting forms and increased co-operation under the Information-Sharing Agreement will enable regulators to ensure consistent application of the harmonized rules, with minimal interprovincial barriers to trade in financial services. Work delineating regulatory accepted accounting principles (RAAP) and the application of generally accepted accounting priniciples (GAAP) to financial institutions has been recently initiated by a subcommittee formed for that purpose.

While further work on technical aspects of risk-weighting for capital adequacy, its relationship to the investment rules, and on corporate governance rules may be required in the harmonization process, ministers agree to continue to work towards a consistent approach to provinces' treatment of extraprovincial companies. Other outstanding issues for harmonization include corporate powers, non-arm's length transactions, and networking.

5. Conclusion

At the inception of the interprovincial conference of ministers in Quebec City in December, 1988, provincial ministers identified the primary objective of the conference as harmonization of financial institution regulation. In so doing, ministers recognized the importance of open access to domestic financial markets for Canadian financial institutions in fostering efficient intermediation between savers and borrowers and ensuring the soundness of the provinces' regulatory frameworks.

Fundamental and far-reaching changes in the financial sector necessitate an unprecedented degree of co-operation among provinces. Securitization, financial innovation, and rapid technological advances are among the forces altering the nature of financial intermediation and contributing to an increasingly competitive financial marketplace. In Canada, the blurring of the four pillars has increased domestic competition considerably.

The globalization of financial services is increasingly evident. In responding to these international forces, provincial ministers have made significant progress in eliminating domestic impediments to capital movements by reaching agreement

on the underpinning regulatory issues of capital adequacy and investment rules. Agreement on these pivotal issues and ongoing co-operation among regulators under the Information-Sharing Agreement constitute a solid basis for further progress on outstanding issues and in other sectors of financial institution reforms.

The Ministers expressed confidence that additional constructive results will be obtained through an ongoing process of harmonization. Ministers expressed a desire to extend the process to other segments of the financial sector.

APPENDIX 1

LIQUIDITY REQUIREMENT

Liquidity

A company is required to maintain unencumbered "liquid assets", net of "specified borrowings" at least equal to 20 percent of its short-term liabilities coming due and payable within 100 days or less.

> "Specified borrowings", mean demand loans or loans having an original term to maturity of seven days or less, including accrued interest.

Short-term Liabilities

The following are considered "short-term liabilities" for the purpose of calculating liquidity:

- deposits payable within 100 days or on 100 days' notice or less including demand deposits;
- bonds, debentures, notes, loans or other similar liabilities payable within 100 days or on 100 days' notice or less, excluding any "specified borrowings";
- loans or securities guaranteed by the trust company that are payable within 100 days or on 100 days' notice or less; and
- interest accrued on short-term liabilities.

Liquid Assets

The following are considered liquid assets for the purpose of calculating liquidity:

- at book value, cash and demand deposits in a financial institution duly authorized to take deposits in Canada;
- at book value, Treasury Bills of Canada or a province;
- at book value, term deposits, bearer deposit notes and other similar instruments issued by a financial institution duly authorized to take deposits in Canada that have a term of 100 days or less or mature within 100 days;
- at book value, bankers' acceptances that mature within one year;
- at market value, securities issued or guaranteed by a government of Canada, a province, a territory or a municipality;

- at book value, demand loans, other than loans to an individual, which are fully secured by Treasury Bills, term deposits, bearer deposit notes, bankers' acceptances which mature in a year or less, or securities issued or guaranteed by a government of Canada, a province, a territory or a municipality; and

- interest accrued on the above items.

APPENDIX 2

CAPITAL BASE DEFINITION

The following summarizes the consensus on the harmonized definition of capital base.

(a) Components of Capital

1. Permanent Capital

- Share capital
  - Shares with no purchase or redemption privileges, that are non-cumulative, and if convertible, are only convertible into other shares qualifying as permanent capital 01

- Other
  - Contributed surplus 02
  - Retained earnings or deficit 03
  - Subtotal 04

2. Non-Permanent Capital

- Share capital
  - Shares with purchase and/or redemption privileges and/or cumulative, and if convertible, only under specified conditions[1] 05

- Subordinated items
  - Subordinated bonds, notes, debentures and other debt instruments, and if convertible, only under specified conditions[1] 06
  - Subordinated shareholders' loans, and if convertible, only under specified conditions[1] 07

- Convertible non-permanent capital
  - Permanent capital convertible into non-permanent capital 08

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[1] Non-permanent types of convertible capital are eligible only if they are convertible into other types of eligible non-permanent capital or if they are convertible into permanent capital. Once non-permanent capital is converted into permanent share capital, it is eligible as such.

Subordinated capital must be subordinate to deposits and all other obligations except instruments which qualify as capital.

- Subtotal (maximum 50% of line 04 or 100% of line 04 if items are amortized; and, for the purpose of the borrowing multiple only, non-permanent share capital to be counted first) 09

3. Miscellaneous Items

- Deferred income taxes payable 10

4. Total (lines 4, 9 and 10) 11

(b) Deductions

- Goodwill and other intangible assets 12

- Equity investments at equity method of accounting and other investments which are included in the capital base of a subsidiary or "associate"[2] that is a trust or loan/savings company, to the extent necessary for the subsidiary/associate to meet its capital base requirement[3] 13

- Equity investments at equity method of accounting or other investments in a subsidiary/associate other than a trust or loan/savings yet regulated entities (i.e., insurance companies and securities dealers), except investments that are not subordinated 14

- Aggregate of equity investments at equity method of accounting and other investments in unregulated financial or non-financial subsidiaries/associates, except investments which are not subordinated, in excess of 2% of the parent company's total assets 15

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[2] "Associate" is a downstream company of which the trust or loan company holds 10% or more, without control, of the voting rights attaching to all shares.

[3] Components of a trust or loan subsidiary's capital base that are in excess of the minimum necessary to meet the subsidiary's capital base requirement may be included in the parent's capital base to the extent permitted by the parent's capital base calculation.

- Market value deficiency of securities (excluding securities issued or guaranteed by a government)[4] 16

- Market value deficiency of real estate, except own office premises 17

- Deferred income tax recoverable[5] 18

- Deferred foreign currency translation losses net of impact of hedging 19

- Amount of investments not permitted or in excess of limits imposed 20

- Subtotal (lines 12 to 20) 21

(c) Capital Base

- Total capital less deductions 22

(d) Deposits, Loans and Commitments

- Deposits, investment certificates, debentures which are effectively deposits (issued by loan/savings companies) 23

- Borrowings including overdrafts[6] 24

- Borrowings by a subsidiary which are guaranteed by the parent 25

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[4] Treatment of market value deficiencies has been referred to a subcommittee on Regulatory Accepted Accounting Principles (RAAP) for consideration of potential problems arising from the determination of market value deficiency on real estate and securities and to make recommendations. Pending those recommendations, the deduction of market value deficiencies will be retained.

[5] The subcommittee on Regulatory Accepted Accounting Principles (RAAP) will review the implications of the treatment of deferred charges generally for the reliability of financial statements and the capital adequacy test. The subcommittee will also consult with the Canadian Institute of Chartered Accountants (CICA) on this matter and market value deficiencies.

[6] Borrowings include such things as bank loans, borrowing from the Canada Deposit Insurance Corporation (CDIC), and mortgages owed by the company.

- Subordinated bonds, notes, debentures and other debt instruments and subordinated shareholders' loans not assigned to capital base 26

- Accrued interest on the items above 27

- Subtotal (lines 23 to 27) 28

(e) Borrowing Multiple

- Total deposits, loans and commitments/ capital base 29

(f) Excess Liquidity

- The borrowing multiple may be expanded if the excess over authorized borrowings is invested in liquid assets not required for the 20% liquidity ratio and the following conditions are met: (a) regulatory approval is obtained; (b) the excess is maintained for 3 months only; and (c) the amount of the excess is not over 3% of authorized deposits loans and commitments.

APPENDIX 3

MINIMUM QUALITY ASSET RULE

At least 45% of the assets of the company excluding assets of subsidiaries, shall be maintained in:

1. securities issued or guaranteed by the Government of Canada, or of a province or a territory of Canada or by any of their agencies or by a university, municipality, hospital or a school board in Canada;

2. loans or leases to the Government of Canada, or to a government of a province or a territory of Canada or to any of their agencies or to a university, municipality, hospital or a school board in Canada or loans guaranteed by the Government of Canada or a province or territory;

3. securities on which payment is ensured by rates or by the levy of a tax by a municipality or school board under a law of Canada or a Canadian province or territory on property situated in the territory of the municipality or school board;

4. first mortgages upon real estate in Canada in an amount not greater than 75% of the market value of the charged property, unless approved or insured within the meaning of the National Housing Act or unless the excess amount is guaranteed or insured by the Government of Canada, or of a province or a territory of Canada or by any agency thereof or under a hypothec insurance policy issued by an insurance company authorized to carry on business in Canada;

5. securities on which payment of principal and interest is guaranteed by the grant of a subsidy by the Government of Canada or of a province payable out of the sums voted each year for that purpose;

6. debt securities other than subordinated debt securities, including bankers' acceptances, issued or guaranteed by a financial institution duly authorized to carry on business in Canada[1];

7. deposits with financial institutions duly authorized to take deposits in Canada.

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[1] Financial institutions considered for the purpose of this rule are credit unions, banks, trust and loan companies, and insurers.

APPENDIX 4

COMMERCIAL LOAN DEFINITION

Definition

"Commercial loan" includes loans, investments and other financing in the form of leasing, guarantees, letters of credit, or letters of guarantee, but excludes:

1. quality assets enumerated in the minimum quality asset rule;[1]

2. loans which are fully secured by quality assets;

3. letters of credit, letters of guarantee, and guarantees which are fully secured by quality assets;

4. fully secured mortgage loans if the outstanding amount of the loan, together with any prior or equally ranking encumbrances and accrued interest, is either not in excess of 75% of the value of the property at the date of the mortgage or the excess is insured[2];

5. debt securities and preferred shares that are widely distributed[3] and common shares;

6. loans to, loans fully secured by securities issued or guaranteed by, or securities issued or guaranteed by any foreign government that is a member of the Organization for Economic Cooperation and Development (OECD), or any of their agencies;

7. the aggregate of loans, leasing, conditional sales contracts, letters of credit, guarantees, letters of

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[1] See Appendix 3 for a definition of quality assets.

[2] Concern was expressed respecting the granting of commercial mortgages on real estate on which there is insufficient income to service the debt. Provinces will carry out further research in this area.

[3] a security is widely distributed if;

(a) it is traded on a recognized stock exchange, is issued by way of prospectus, and is issued by a body corporate; or

(b) if it is issued to more than 25 investors within a 6 month period, no one of which holds more than 10% of the total amount of the securities issued and on an ongoing basis the financial institution does not own more than 10% of the securities outstanding and no other person more than 90%.

guarantee and other financing to an individual in an amount of $250,000 or less;

8. investments in equity, loans or other commitments that are subordinate to unsecured debt in subsidiaries or associates; and

9. investments in real estate.

Purpose

The definition is designed to identify all commercial credit including loans and loan substitutes for the purpose of applying a separate portfolio limit, capital threshold and regulatory approval process to a type of intermediation which is viewed as inherently risky, particularly from the standpoint of credit default. Elements of the definition may be eliminated at the time that a risk-weighted capital adequacy model is adopted (i.e., off-balance sheet financing).

(See quantitative limits in Appendix 6).

APPENDIX 5

PERMISSIBLE SUBSIDIARIES/ASSOCIATES

The following is a list of permitted subsidiaries or "associates" (i.e., 10% or more investments, without control) agreed to in principle, subject to an overall portfolio limit of 5% of the parent's assets, excluding trust and loan subsidiaries/associates[1]:

Data processing/information management

Factoring

Financial leasing

Ancillary corporations

Foreign financial institutions

Investment counselling

Mutual fund distribution corporation

Portfolio management

Real property brokerage

Real property corporation

Management service corporation

Insurance company[2]

Securities dealers

Bank

Trust company

Loan company

Approval of Ownership and Investments

Quebec will allow certain types of subsidiaries/ associates automatically (financial leasing, investment counselling, portfolio management, mutual fund distribution, real property brokerage, real property, trust and loan, and securities dealers) and the remainder of the list could be allowed subject to Ministerial approval.

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[1] The definitions of and the scope of activities of the subsidiaries and associates are still under consideration.

[2] Insurance company may include insurance agencies where permitted by that province.

However, approval of the ownership of a 10% interest in Quebec incorporated trust or loan/savings companies is required elsewhere in the Quebec Act, as is the case in Ontario (for both Ontario and extraprovincial corporations), Alberta (proposed), New Brunswick, Saskatchewan and for all financial institutions incorporated in British Columbia under the British Columbia Financial Institutions Act.

APPENDIX 6

QUANTITATIVE INVESTMENT RULES

QUANTITATIVE INVESTMENT RULES

Companies must follow a prudent portfolio approach which, at a minimum, includes the establishment of written policies and procedures and an annual review of those policies and procedures by the board of directors or a committee of the board of directors.

Consensus has also been reached on harmonizing the following specific rules in addition to those set out in previous appendices.

Commercial Loans[1]

(1) All companies automatically permitted to invest up to 5% of assets in commercial loans.

(2) Companies must have greater than $15 million in regulatory capital to invest in greater than 5% in commercial loans up to a maximum of 20%, the actual percentage between 5 and 20% will be set by each jurisdiction at the time of approval for each company.

Shares

(3) Maximum investment in shares not included in the commercial loan definition (i.e., widely distributed preferred shares and common shares) of all bodies corporate other than subsidiaries or associates is 10% of the company's assets.

(4) Maximum of 10% of voting rights in any one body corporate, other than eligible associates or subsidiaries.

(5) Limits on downstream investments specified in (3) and (4) do not preclude holding shares as a result of realizing on security but shares held because of realization must be disposed of within 2 years or longer with regulatory approval.

Subsidiaries and Associates

(6) Maximum investment in equity, loans, and other commitments that are subordinate to unsecured

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[1] These limits may be subject to further harmonization discussions among provinces as it is appropriate to anticipate the possibility of changes in this limit following additional consultation and empirical tests, taking into account the broadness of the new definition of commercial loans.

debt, in subsidiaries/associates is 5% of assets (excludes loan or trust subsidiaries/associates).

Personal Loans and Leases

(7) No upper aggregate limit on personal loans and leases; amount of limit on personal loans to individuals determined by commercial loan definition (i.e., over $250,000 to be counted as commercial loans)[2].

(8) No regulatory authorization required for level of personal loan and lease portfolio, except that prior notification requirements may be imposed as to the company's plan in connection with limits on, and outstanding aggregate amounts of, personal loans and leases. Plans should be consistent with sound business and financial practices.

Mortgages

(9) Investments in third or subsequent mortgages limited to 2% of assets, but limit does not preclude taking additional security in the form of third or subsequent mortgages.

(10) Mortgages loans together with any prior or equally ranking encumbrances and accrued interest cannot exceed 75% of the value of the property at the date the mortgage is granted unless the excess is insured.

Real Estate

(11) Maximum aggregate investment in real estate for company and unregulated subsidiaries is 10% of the parent's and the unregulated subsidiaries' assets, other than real estate acquired by way of foreclosure within the last 7 years.

(12) Maximum of 1% of the total of the assets of the parent company and the assets of its unregulated subsidiaries invested by the company and its unregulated subsidiaries in any one parcel of property, other than for the company's own use, and other than property acquired through realizing on security within the last 7 years.

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[2] It was agreed that provinces may set out more restrictive requirements on personal lending either in terms of aggregate limits or individual loan limits.

Investments in Related or Associated Persons

(13) Maximum investment or loan to any person or group of related/associated persons is the greater of $500,000 or 1% of assets, other than loans to or investments in subsidiaries[3] and quality assets that are issued by governments or issued or guaranteed by governments or government agencies.

Leasing

(14) Minimum controls on commercial and personal leasing in the form of minimum residual values and similar rules[4].

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[3] The definition of persons who are "related" or "associated" is:

a. one is a spouse or child of the other;

b. one is a relative of the other or of the other's spouse and has the same home;

c. one is a body corporate controlled by the other, and affiliates of the body corporate;

d. one is a partner of the other; and

e. one is a trust or estate in which the person has a beneficial interest or as to which the person serves as trustee or in a similar capacity.

[4] Proposed restrictions on leasing are under discussion.